MMF Reforms Risk Missing the Point

Money market funds are once again in the cross hairs of regulators in the US and Europe following a brief liquidity crunch in March 2020. Sebastian Ramos, Executive Vice President, Global Trading and Products, ICD, discusses the risks that over-zealous reforms could pose to the popular short-term investment instruments.

By **Ben Poole**, Columnist

During the global financial crisis of 2008, the original money market fund (MMF) - the Reserve Primary Fund - 'broke the buck.' As a result of its net asset value (NAV) falling below $1 for the first time, after the crisis both US and European regulators moved to amend the rules for MMFs.

This process had two stages in the US. The first targeted the underlying cause of the crisis by focusing on quality of portfolio, duration and portfolio transparency. The second focused on firming up an approach to liquidity and implemented the floating net asset value (NAV) for MMFs in the US.

In Europe the approach was similar but not as strict as in the US. As Ramos explains: "Rather than imposing a floating or variable NAV, a low volatility NAV [LVNAV] was introduced." This tightens the spread at which a fund will have to reprice itself and start floating. "Historically, the funds had used penny-rounding with the fund having to reprice itself if there were a 50 basis point deviation of market value compared with the amortised cost value."

What the regulators did for LVNAV was to narrow that spread to 20 basis points. Ramos continues: "In the US, funds now have to float out to four decimal places based on its mark-to-market value. Whereas, in Europe, regulators essentially kept the NAV stable but instituted a tighter band at which mark-to-market had to reflect or be in line with the amortised cost valuation."

Europe also took a slightly different approach to liquidity. In the US, the rules mandate that if the liquidity of a fund drops below 30%, the fund's board must determine if it wants to impose fees or gates on any redemptions. In Europe, regulators took a similar line, but focused on the root cause of the redemptions they were trying to prevent. Here, when it hits the 30% liquidity level, the fund must also have a 10% reduction in the portfolio's assets under management (AUM) on a given day to trigger the board meeting.

This 10% AUM drop is more indicative of a mass withdrawal or 'run' on a fund, as opposed to simply dropping below the 30% liquidity level.

"These are the two main differentiators," says Ramos. "There's a similar thought process, but the withdrawals that we saw when Covid-19 was declared a pandemic were much more significant in the US, in part because of the way the regulations were structured in the US versus the way they were in Europe."

Testing the reforms

The duration of withdrawals from MMFs in March 2020 due to the Covid-19 liquidity crisis was relatively short, with heightened redemptions occurring for around five to seven days.

"It was not like another credit crisis, it was about liquidity," explains Ramos. "While there were large outflows, they were fairly orderly. But there was significant concern that if everybody was pulling out from the prime MMFs then there could potentially be a loss of liquidity. This could come from a gate preventing withdrawals from the fund, or redemption fees impacting the principal that investors could recover."

Across the board, but more significantly in the US, there were redemptions out of prime MMFs and an asset rotation into government MMFs, where there were fewer concerns about liquidity due to the credit quality of the portfolio as well as how the rules treat liquidity in such MMFs.

"Everyone was moving out of prime MMFs, where there might be some liquidity concerns, and into government MMFs as the primary liquidity vehicle of choice," Ramos recalls.

Once again, there were some marked differences between the US and Europe in this respect. In the US, there were significant outflows of prime MMFs. At its peak, ICD saw approximately 80% of its prime money market assets sold within those few days in the middle of March 2020. In Europe, it was significantly less, at around 30%.

"The 30% liquidity rule in the US made everyone concerned about potentially not being able to access their cash and losing liquidity in the vehicle," says Ramos. "This would be only temporary, but any constraints were of concern to investors. The effects of that on redemptions were much more significant in the US. In Europe, we saw fewer withdrawals among our client base."

During the days of 'money fund madness,' the US government stepped in. The Federal Reserve restarted its Commercial Paper Funding Facility and the next day instituted the Money Market Fund Liquidity Facility as a backstop. At that point, the significant withdrawals eased. Looking back at that period, the main issue that ICD observed was the impact of the 30% liquidity rule directly tied to the potential imposition of fees and gates.

"In the US, there were three funds that got to the point where they were breaking that threshold," continues Ramos. "Instead of dipping into the 30% liquidity buffer designed specifically for this purpose, two funds decided to purchase securities out of the portfolio, to avoid hitting the 30% mark. These funds were more concerned about having to meet as a board and the fallout from the potential for fees and gates than breaking that threshold. This created an artificial red line where there's a liquidity buffer that's created to help with large redemptions and meet liquidity needs, but which certain funds were uncomfortable or unwilling to tap into. Effectively, their liquidity became strained because of the way the rules were structured."

In Europe, due to the LVNAV, none of the NAV in the funds moved. While there was some deviation in terms of market value, it never got close to the 20 basis point collar. By contrast, in the US where funds were already priced out to four decimal places with a variable NAV, the NAVs went down for a few days.

"The NAVs in the US fell to the point where clients in the funds were concerned about potential losses," says Ramos. "Temporary dislocations in the mark-to-market value of the securities, which was going on across the marketplace, were impacting MMFs as well. That potentially contributed to redemptions being far more significant in the US than they were in Europe."

Regulatory responses

Following the events of March 2020, regulators on both sides of the Atlantic have been looking closely at the liquidity

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provisions and exploring the potential for restructuring. In Europe, regulators are analysing the benefits of taking the same approach as the US and essentially getting rid of LVNAV and moving to a variable NAV for MMFs.

"What's interesting about the European approach now is that we saw what happened due to the differentiation between the US and Europe in March last year, and I'm not sure that's the direction they should want to go," cautions Ramos. "You have to remember that there are already variable NAV MMFs in Europe, and they are significantly less utilised than the LVNAV MMFs, in part because of the way corporations like to use these products. They like a more stable value where at all possible, which makes it much easier from an accounting perspective. Also, they want to feel comfortable that they can have access to their cash and there aren't going to be liquidity concerns around fees or gates, for example."

Public commentary on the regulatory proposals in both the US and Europe has passed, although the ultimate reforms that might come about as a result of the events of last year are not yet set in stone. Overall, MMFs continue to be a valuable investment vehicle for those managing cash and short-term investments. They have distinct advantages in some areas as part of an investment portfolio from a diversification perspective, and they can also offer competitive yields in the marketplace.

"We hope that in trying to prevent similar issues arising, the regulations don't make it so that the funds are significantly less attractive," Ramos says. "One area that clients will go to is bank deposits, as well as looking to raise money from banking partners, and that could have a couple of effects. It could obviously create more concentration in an already systemically important area. Potentially it could also have the side effect that smaller companies, and those with less of an embedded relationship with their banks, will face more difficulty in placing deposits and raising funds. Big MMFs still perform as an important source of liquidity for those investing but also for those looking to raise cash as well."

Finding the right balance

As part of the regulatory review, ICD has written to the US Securities and Exchange Commission (SEC), the European Securities and Markets Authority (ESMA) and the Financial Stability Board (FSB). The letters stress that the main issue that caused most of the redemptions were the liquidity provisions funds faced, to the point where they were uncomfortable in tapping that extra buffer when they really needed it.

"Our focus has been on ensuring that regulators clearly understand that what happened last year was a liquidity issue," states Ramos. "You can clearly see the differentiation between the rules, and then what happened in the market, in the US versus Europe. Additionally, on the European side, we want to illustrate what happened to MMFs from a variable NAV perspective as well, and how that exacerbated the issue in March 2020."

Ramos points out that in 2016 when the second round of reforms were made in the US to adopt a variable NAV and support liquidity fee and gate provisions, there was a significant move away from these funds as a result.

"They dropped around $800bn in terms of size and importance in the marketplace," he recalls. "As European regulators think through whether they want to impose a variable NAV, we want to highlight that those funds already exist in Europe and are underutilised. If this is implemented, something similar to the US could happen within Europe, with many investors choosing not to use these products as a cash alternative because of the floating NAV."

The point of the letters that ICD has written to the SEC, ESMA and FSB is to highlight where past regulation has had unintended consequences on the performance of MMFs, and urge the regulators to reflect on these as they propose yet more reforms to the money fund market. Ramos has a regulatory wish list but is also realistic regarding what can be done.

"In a perfect world, we would love to see the tie of the liquidity requirements to the fees and gates to go away," he reflects. "At the same time, we're pragmatic in that we don't think that regulators would say they need to fix the regulations and, as a result, regulate less. There would have to be some form of give and take.

"Increased liquidity requirements, above 30%, could be a component of that. Ideally, we'd also like the regulators to take a second look at the floating NAV and whether that's really the approach to take. We don't think that's necessarily on the table in the US, but in Europe we certainly would want them to take a close look at the impact imposing floating NAV had on these products in the US – both when it was imposed and also how it operated in the liquidity crisis in March 2020."

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The European Securities and Markets Authority (ESMA) published its Consultation On EU Money Market Fund Regulation – Legislative Review on 26 March 2021. ESMA sought public comment until 30 June 2021. It is expected to publish its opinion on the review of the MMF Regulation in the second half of 2021. On 30 June 2021, the Financial Stability Board (FSB) published its Consultation report: Policy Proposals to Enhance Money Market Fund Resilience, for which it sought public feedback until August 16. The FSB expects its final report to be published in October 2021.

To further discuss the impacts of money market fund reform with ICD, please contact team@icdportal.com